



* N G Shankar

Enhancing Business Excellence through Internal Audit

Introduction

The world we live in is volatile and uncertain, with challenges that are complex and ambiguous. Business models are rapidly evolving with the introduction of innovative products and processes. Science improves human quantity and quality, technology reduces information complexity and adds network effects, while society attempts to adapt around its social structures in the age of creative disruption. Artificial intelligence is radically changing the skillset of the workplace and might give rise to a new global economic order.

In this day and age, traditional businesses which do not reinvent themselves will go extinct and therefore companies need to think out of the box. Governments across the world have enacted new legislations, governance codes and practices in the age of creative disruption, but obviously cannot keep up. Markets have failed and so have businesses that emanate not just from poor strategy or risk taking at unacceptable levels but also owing to financial fraud and poor governance practices.

While the human condition and the world tomorrow are both difficult to predict, the vigilant application of best practices in internal audit can help mitigate the risk of business failure. More importantly, it can scale business excellence by enabling a solid foundation of systems and processes with adequate checks and balances which are implemented by Executive Management under the stewardship of the Board of Directors. However, this task is onerous. The importance of managing investor expectations, developing a sound business strategy with high quality execution coupled with robust systems, processes, and good corporate governance practices cannot be overemphasized.

Why Internal Audit?

Internal Audit plays a critical role in protecting and enhancing organizational value. As a key element of organizational governance, internal audit has moved from a traditional financial audit or a compliance role to risk-based audit that proactively provides independent assurance, advice and insight in risk management, internal controls and governance. The internal audit activity is increasingly becoming a change agent and a business partner.

The primary role of internal audit is to provide assurance to stakeholders that enterprise risks are managed adequately, internal controls are working as intended, compliance processes are effective and governance mechanisms are robust. Internal auditors are the eyes and ears of executive management and give comfort to the Board and Audit Committee when they provide independent analysis, assurance and insight. They also highlight in a timely manner risk exposures or control deficiencies or identify areas for improving process

effectiveness and efficiencies. Internal auditors keep a close watch on the business and regulatory environment and look for emerging risks.

Checks and Balances in the Fourth Industrial Revolution

The environment of the future will be very different. Ideas, insights and implementation of sciences and technologies stemming from the Fourth Industrial Revolution, will fuse physical, digital and biological worlds, and impact all disciplines of knowledge. Fields such as artificial intelligence, machine learning, deep learning, robotic process automation, the Internet of Things, autonomous vehicles, mixed reality, quantum computing and nanotechnology will transform the way we receive, process and transmit information. The responses of the state, market and society to the Fourth Industrial Revolution will disrupt economy and industry. To that extent, internal audit will be no exception.

Companies will go through different models of ownership, possession and control whilst radical changes in structures of productivity, distribution and management are expected. Shared economy products and services will redefine the socio-political economy. Democratization and decentralization of technologies like block chain will redefine currencies, contracts, commodities and communication.

Thus, the next five to ten years will see enormous changes to the business models and processes. These changes will have increased focus on the customer and environment, keep a check on cost of goods or services, overall contribute to enhanced efficiency and bring further rigor to risk management and internal control. Wielding the power of the Fourth Industrial Revolution will need a considered plan for companies and society to ensure high stakeholder value and better quality of life for the average citizen.

Scaling Businesses using Internal Audit

The practice of internal auditing in the future will be determined by how it adapts to the new business environment and changes to stakeholder expectations, regulations and governance requirements. Many internal audit departments understand big data and analytics, do more with less, and are better aligned with the objectives and goals of the organization. However, with newer technologies that business will imbibe, it is clear that newer risks will emerge. Internal audit will need to gain a deep understanding on these developments and how they will impact their respective businesses.

So let me elaborate seven (7) areas an internal audit activity needs to look at. This should help them transform themselves to provide real time and relevant assurance, advice and insight and assist businesses in their sustainable journey towards long term growth and profitability.

1. Risk Vs Value:

While risk is the central theme, internal auditors need to take a hard look at organisational value. As per the Global Institute of Internal Auditors, the mission of internal audit is "To enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight." The Chartered Institute of Internal Auditors, UK, in a publication on "Effectiveness of Internal Audit in the Financial Services Sector" states that the role of internal audit is "to protect the assets, reputation and sustainability of the organisation"

Internal auditors expect the organisation that they serve be successful over the long term. They focus on the business in a holistic manner, understand the big picture, its current risk profile and emerging risks. However, it may be useful to ask the question "What is the fundamental economic value of the business?" They can review strategic plans and financial results reporting, analyse information such as the business model, enterprise purpose, strategic goals and have an engaged discussion with management on the mission. The next question may relate to "How is value created?" which can be addressed in a variety of ways- by reviewing products and services through their margin analysis, looking at key business processes and improvement efforts, reviewing financial and costing information, making enquiries with operating management and also seeking views from external sources about the organisation. The third most important question would be "What can destroy value?" Internal auditors need to continuously review the risk information, both internal and external, the likelihood of an event happening that may have a negative effect on the company. Clearly, significant fraud or poor governance and systems will shake public trust and confidence which will be ultimately reflected in their market valuations or public opinion.

2. Utilize the Power of Information Technology in Audit:

Information Technology is an enabler to business. Its deployment in business will only increase over the years. Internal auditors must understand and assess emerging risks related to newer technologies and engage closely with business leaders and operational management. However, an important area would be for the internal audit activity to make an assessment of how internal auditors can use technology and tools in the audit work. Questions often asked are "How many of the audit processes are automated and how many are manual?", "how much time is spent in writing audit reports?", "how quickly are the final reports released after the audits are completed?"

Many internal auditors use data analytics especially in business sectors that generate a lot of transactions. Can more of this be done or can this be performed differently to better support audit results? Have auditors looked at unstructured data? Can internal audit processes be more automated, such as controls testing by bots; when deployed, these initiatives will free resources for higher end work.

3. Continuous Assessment of Audit Risk:

Audit risk is the risk that an audit in a particular area does not reveal a major design gap, a key control failure, procedural irregularity, or significant fraud. It is important for the audit leadership to deliberate on what further needs to be done to better control the future of the organisation. We need to ask ourselves whether we are missing something? Is the glass half full or half empty? So the question is how can we reduce audit risk? When choosing subjects for an audit and developing the audit program, the internal auditor will need to understand the audit risk and evaluate how it can be reduced. One method would be to increase sample size or perform extensive analytics or use newer tools or get into newer areas or involve domain experts in the review team. The results are likely to be impactful and

will surely bring greater credibility to the internal audit activity.

4. Newer Areas for audit:

Typically, internal auditors develop a periodic audit plan based on a risk assessment. While the plan will largely include the traditional business processes, some audit functions may be performing environmental, sustainability audits or reviews around digital initiatives and social media if these pose major risks to the business. While this may be so, it may be very useful for management to get an outside-in view. How about performing internal audit work that is related to outside the organisation?

In business sectors such as fashion, food retail, telecom, financial services, or even FMCG, customers and their behaviour play a pivotal role in the future success of the organisation. Internal auditors can perform work around those external to the organisation- such as customer-centric processes, customer complaints or feedback reviews, or by visiting franchisees, distributors, retailers, agents and even vendors in order to obtain feedback on what they think of the company values, processes and commitments.

In information system practices, it is believed that security breaches occur primarily owing to the employee within either wilful or otherwise. The most useful information would be to predict employee behaviour through their conduct and actions. Is the management doing something about this? Can internal auditors use techniques and procedures to assess behaviour of employees? For example, can phishing mails be sent to employees, as a sample, as though it is being sent from outside the organisation. One can analyse their reactions to these phishing mails and provide insightful results to the management.

5. Auditing Organizational Culture

Organizational culture is an important constituent of the control environment in an entity. It will continue to play an important part in an organisation in their journey towards excellence and business success. As long as businesses are managed by human beings and not robots, this should be a key focus area by the internal auditors.

Culture can be defined as a system of shared meaning and belief held by employees in an organization that determine how they act. It influences the way employees behave. Strong organizational culture contributes effectively to higher performance. When an organization's culture is strong, it positively affects the thinking of the employees towards internal as well as external stakeholders and it helps in a better response for achievement of organizational goals.

In addition to this, there are also subcultures within and different cultures in the organisation. This challenge is an opportunity for internal auditors because it can be very much identified during audits. There is no right culture and no ideal balance between risk and reward, even for different functions of the organization. For example, procurement may have a conservative culture, and sales may have an aggressive culture, which may be appropriate within certain norms. Often, when two companies merge, one of the critical aspects is the meeting of the minds of the two companies and their cultural integration.

An organization's culture does not exist in formal documents such as code of ethics or value statements, which only reflect what the organization says it wants the culture to be. They can describe what they think the culture is, but their perception of the culture is filtered by employees' unwillingness to tell them that there are problems in the culture. The culture exists in the perceptions of employees. If employees believe the culture is "win at all costs, do whatever it takes," or "put the customer first," that's the way they behave. A common

definition of culture could be "how we do things around here."

Auditing an organization's culture can be challenging because of its complexity, its subjectivity, and the potential resistance of key players. Performing a control environment assessment at the entity level will be a good beginning. There is a need to factor this in the process audits that are undertaken. Internal auditors should evaluate the culture differences and put them into perspective; they can then determine whether there are some gaps and if so, whether something needs to be done to correct it.

Using good techniques, judgment, professional scepticism and communication skills, internal auditors can present solid evidence about the culture to executive management and the board. Over time, the picture this evidence reveals will become clearer and more persuasive especially when something goes wrong. This may be very valuable information that internal audit can provide.

6. Hire smart talent: The internal audit agenda of the future will need different resourcing strategies. Typically, many internal audit departments have a multi-disciplined team that includes accountants, engineers, management graduates and domain specialists. A high performing team can be defined as a group of people with specific roles and complementary talents, aligned with and committed to a common purpose. They consistently show high levels of collaboration and innovation, which produces superior results. Highly effective teams have high dose of "energy, engagement and exploration" (MIT Human Dynamics Laboratory study)

Traditional hiring practices of focusing on risk and control specialists with internal audit experience may not be effective. There is a strong case for inducting more domain experts in the audit team. Many audit departments already have information security professionals, ERP specialists or project management experts or those with line function experience in related domains. A few audit departments have hired data scientists in the data analytics team and perhaps a block chain expert in the future. Their insights in process reviews would be very valuable. Internal auditing can be easily learnt by the business domain experts but not the other way around.

Internal audit leaders must have the budget and authority to experiment with new resourcing strategies considering the future audit agenda, business priorities and the talent gaps.

7. Building Leadership through Coaching: It is important to build and sustain a high-performing internal audit team which may also consist of co-sourced professionals from an external firm. The Chief Audit Executive must lead the way and bring a coaching culture within the team, build the leadership pipeline and enable staff to take up higher roles and responsibilities. The Chief Audit Executive must be able to bring out the best in the team, while balancing multiple needs of career growth, travel, and work-life balance.

Concluding thoughts

Agility, innovation, and out of box thinking are an integral part of the transformational journey. Each internal audit department will need to make an objective assessment on where they are, what they need to do and how they should achieve their goals in a defined time frame. It is always easy to tap the low-hanging fruits but the challenge would be when investments need to be made for use of the right technology or on hiring talent for which the business must support the budget. In the longer term, the business will gain from these investments.

Internal auditing is now being increasingly recognised worldwide as a separate profession and a critical player in the governance structure. With the growth of the business enterprise and the new business environment, the expectations from internal auditors will only increase. It is entirely on the professionals to ensure that they do not belie the trust reposed by the stakeholders. We must do the best we can, be future focused, remain independent at all times, act with integrity and communicate the bad news with courage and conviction.

** N. G. Shankar FCA, CIA, CISA has a professional experience of 36 years in diverse industry verticals. He retired recently as Group Executive President- Corporate Audit from the Aditya Birla Group (ABG). Mr. Shankar has been actively involved in several honorary positions with the Global Institute of Internal Auditors and is also trained as a performance coach.*

NEWS&VIEWS

PM SPEAKS

10-point agenda for ISA

- Ensure that better and affordable solar technology is available and accessible to everyone.
- Need to increase the solar proportion in our energy mix.
- Encourage innovation so that solar solution can be provided for various needs.
- Provide concessional financing and low-risk finance for solar projects.
- Developing regulatory aspects and standards which will speed up adoption & development of solar solutions.
- Developing countries will have to develop consultancy support for bankable solar projects.
- Emphasis on greater inclusiveness and participation in our efforts.
- Building an extensive network of centers of excellence that can take care of the local conditions and factors.
- Solar energy policy may be viewed from the angle of the totality of development so that we get more and more contribution towards achievements of SDGs.
- To strengthen ISA secretariat and make it professional.